

THE CURRENCY ACT OF MARCH 14, 1900

BY

JOSEPH FRENCH JOHNSON

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SINCE the resumption of specie payments in 1879, the monetary system of the United States has been weak in three respects: (1) The United States Treasury, although responsible for the convertibility of a large mass of credit money, has had inadequate control of its resources and only an artificial connection with the money market; (2) there has been no definite legal provision for the maintenance of the gold standard; (3) the bank-note currency, instead of responding to the needs of the money market and thus lightening the Treasury's burden of redemption, has failed to be of any service, either in normal or in critical periods.

In this paper it is my purpose to consider the general effect upon the situation of the Currency Law of March 14, 1900. Does it break the "endless chain"? Does it render easy the maintenance of the gold standard? Does it make impossible the recurrence of the critical times of 1894, 1895 and 1896? Are the amendments to the National Bank Act an improvement or the opposite? Questions of this character I propose to discuss: I will not stop to analyze or criticise the act in detail.

I.

It should be noted, first, with respect to the act, that the gold standard is no more than a statutory declaration of an existing fact. Since 1873 gold has been the standard money of the United States, and no alternative has been possible. The law of 1878 authorizing the coinage of silver dollars, although it called them standard dollars and made them full legal tender, was not, as is often assumed, a step toward bimetallism. The silver dollar was between 1878 and 1890 a piece of fiat money. The real dollar of the United States was 25.8 grains of standard gold, and its purchasing

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power depended entirely upon the value of gold. The silver dollar in our monetary supply occupied the same position as that held in Germany and France by the silver thaler and the silver five-franc piece. Technically it was fiat money, but implicitly and practically it was credit money. It was not a promise to pay gold, and there was no provision for its redemption in gold; yet the United States government, having made it a legal tender, could not have permitted it to fall below parity with gold, without great injury to the national credit. The law making it legal tender practically pledged the faith of the government as a guaranty of its equivalence with gold. In the Sherman Act of 1890 the parity clause formally recognized the government's obligations with regard to the silver dollar, and so made it a piece of credit money, redeemable, not directly in gold, but in equivalent value.

So far as the silver dollar is concerned, the act of March 14 writes nothing new upon the statutes. Section 1 is merely a combination of the laws of 1873 and 1890. It names gold as the "standard unit of value" and declares that all forms of money issued or coined "shall be maintained at a parity of value with this standard," it being "the duty of the secretary of the treasury to maintain such parity." The status of the silver dollar, therefore, remains exactly what it has been since 1890.

In the status of the greenback and of the treasury notes of 1890, however, the law makes a definite change. Until 1890 the greenback was a "coin" obligation and was legally redeemable in either gold or silver. The law of 1890, while leaving it still a coin obligation, made its redemption in gold compulsory, whenever such redemption was necessary to maintain its parity with gold. The act of March 14 makes the greenback and the treasury note both gold obligations, declaring that they "shall be redeemed in gold when presented to the treasury for redemption."

Thus, with regard to the greenback and the treasury note, the law becomes clear and imperative, where before it was vague and inferential. It simply makes mandatory upon the secretary

of the treasury a policy which by improper construction of preëxisting statutes he might have avoided. This part of the law is most satisfactory, for there should be no room for discussion about the convertibility of paper money. Yet the vagueness of the law prior to March 14 did not leave an opening for so much mischief as has often been assumed. If Mr. Bryan had been elected president in 1896, a free silver secretary of the treasury might, indeed, have insisted upon the redemption of greenbacks with silver dollars, but he could not thus have thrown the country upon a silver basis, for he could not have caused any inflation of the money supply. The adoption of such a policy would undoubtedly at first have shaken the foundations of credit and lifted gold temporarily to a premium, but the level of prices could not have been much affected.

The law makes very elaborate provision to insure the redemption of the greenback in gold, without embarrassment to the treasury. The pocket money of the people hereafter is to be silver certificates. Greenbacks are to be issued only in denominations of ten dollars and upward. The treasury notes of 1890, of which only about \$80,000,000 are now outstanding, are to be retired during the next two or three years and silver certificates issued in their stead. Hence, the \$346,000,000 of greenbacks now outstanding are the only form of money for the direct redemption of which the treasury is to be responsible. The law creates a gold redemption fund of \$150,000,000 and provides that greenbacks once redeemed shall not be issued again except in exchange for gold. The reserve fund evidently is always to stand at \$150,000,000, and may consist partly of gold and partly of greenbacks.¹ The secretary of the treasury may exchange greenbacks in this fund

¹ The reserve fund can never rise above \$150,000,000, including both gold and notes. It will necessarily fall below this sum, however, if the secretary shall ever take advantage of Section 3700 of the Revised Statutes and buy gold at a premium, for then the amount of greenbacks taken from the fund will exceed the amount of gold added to it. If the fund once fall below \$150,000,000, it apparently cannot be restored to that figure until the amount of gold in the fund chances to fall below \$100,000,000, when the secretary must sell bonds and restore the gold "to the maximum sum of \$150,000,000."

for gold in the general fund of the treasury. But whenever the gold in the redemption fund falls under \$100,000,000 and cannot be increased by exchanges of greenbacks for gold in the general fund, the secretary must obtain gold by the sale of bonds sufficient to bring the gold in the reserve fund up to \$150,000,000. The greenbacks thus released from the reserve fund will pass into the general fund of the treasury and may be used for any purpose except "to meet deficiencies in the current revenues." Thus, the law provides for the certain redemption of the greenback. It leaves no discretion with the secretary of the treasury. When his gold fund is depleted, he must sell bonds.

It is to be noted that these provisions of the law do not confer upon the secretary of the treasury any new authority. They merely prescribe a policy which he formerly had authority to pursue, if he deemed it wise. Under the War Revenue Act of 1898 he had authority, and still has, to issue three per cent bonds for any lawful purpose, whenever in his judgment it is necessary. Hence, even though the act of March 14 had not passed, the secretary would still have had authority to maintain the gold fund at \$150,000,000 and to issue bonds for its replenishment whenever it became depleted. The peculiarity of the law of March 14 is its mandatory prescription of a policy conceived to be sound.¹

¹ Professor Laughlin's view, set forth in the July (1900) *Journal of Political Economy*, that the gold standard is not securely established, because certain obligations of the government may be paid in silver dollars, although no means are provided for their redemption or for the maintenance of their parity with gold, is unduly pessimistic. Government bonds cannot be made a test of the gold standard; for their character is fixed by contract at the time of their issue, and they must be paid in what the letter calls for. By the maintenance of the gold standard is meant that dollars of every kind are kept equal in value to the gold dollar. Experience has proved that such parity can be maintained in either of two ways: (1) By direct redemption, (2) by limitation of the money supply. In the case of the silver dollar, ample provision seems to have been made for the maintenance of its gold value by the second method. Since the free export of gold is provided for by the redemption of greenbacks, and is assured by the borrowing power of the United States, inflation of the money supply sufficient to send silver dollars to a discount is practically impossible. As for the payment of government bonds in silver dollars, that could not disturb the gold standard — to say nothing of the fact that any secretary who undertook such payment would find himself embarrassed by the scarcity of silver dollars at his disposal.

II.

The most important provision of the law is one which does not appear to have been generally understood. In the discussion in Congress very little was said about it and no particular reason was given for its insertion. It is that part of the law which provides that greenbacks taken from the reserve fund in exchange for gold shall not be used "to meet deficiencies in the current revenues." This is a vague expression; but if it is correctly interpreted, it will prove to be the most effective of all the provisions intended to guard against depletion of the gold fund. It is the keynote to a policy which would have prevented the disastrous operation of the "endless chain" in 1894 and 1895, if it had been promptly adopted — as it might have been, for no legal barrier has ever stood in its way. All the other elaborate measures for the preservation of the gold fund are of little consequence beside it. If they were all dropped, the gold reserve would remain as safe as now.

In order to make this point clear, it is well to examine the so-called "endless chain" and to consider some of the theories accounting for its operation. The term "endless chain" is intended to describe the fact that greenbacks may be presented at the treasury in exchange for gold, then paid out by the treasury and again presented as a demand for gold. Since this process, if long enough continued, may exhaust the gold supply of the treasury, the operation of the "endless chain" — in other words, the redemption of greenbacks — is regarded with much apprehension by the average business man. Evidently the "endless chain" can be broken only in one of two ways: (1) By the retirement of the greenback; (2) by the shifting of the burden of redemption from the government to the banks, as was proposed in Congressman Walker's bill, according to which each bank was to become responsible for the redemption of greenbacks, in proportion to the amount of bank notes it issued. Neither of these plans has been adopted. The act of March 14 does not attempt to break the "endless chain," but merely to render its operation innocuous.

The most commonly accepted explanation of the "endless chain" attributes all of the mischief to the greenback. In 1895-96, when the gold reserve in the treasury fell at times below \$50,000,000, a cry promptly went up that, if the greenback were only out of the way, the gold standard would be safe. The idea prevailed that the greenback, being a direct demand upon the government for gold, was maliciously presented for redemption, in order that the treasury department might be embarrassed. People have had the idea that in any time of unusual financial stringency or disturbance the greenback is certain to appear at the treasury windows and so to increase the distress. Thus, in 1894, 1895 and 1896 the heavy redemptions of the greenback were commonly attributed to the fear at home and abroad with regard to the maintenance of the gold standard. It was thought that the agitation for free silver unsettled the faith of Europe in the money of the United States and that, therefore, holders of greenbacks were anxious to convert them into gold before it was too late. In the same way, the heavy exports of gold from this country were accounted for. Foreigners, it was said, sold American securities because of their fear lest they might be compelled to accept silver instead of gold, and these sales, turning the balance of trade against us, necessitated the outward movement of gold. By some the operation of the "endless chain" has been confidently attributed to the wicked machinations of millionaire financiers and bankers in New York City. It is easy to find intelligent men who are convinced that greenbacks were scraped together in 1895 and 1896 and presented to the treasury for redemption by men who wished thereby to force the government into bond issues, in order that they might profit by their purchase and sale.

The trouble with these explanations is the fact that they do not explain. If unscrupulous bankers by manipulation of the greenback can draw gold from the treasury and compel the issuance of bonds to their profit, why have they not worked this scheme oftener? In 1883, for instance, and again in 1885, the gold reserve fell to \$125,000,000, and a syndicate of wicked millionaires might easily have collected greenbacks and

embarrassed the government by demanding their redemption. Nothing of the sort was attempted. In 1883 only \$500,000 in greenbacks were presented for redemption in gold, and in 1885 only \$7,000,000. The year 1884 was marked by financial distress and panic, and there was an abundance of talk then about the insecurity of the gold standard, on account of the Bland-Allison Act of 1878. In fact, all through the 80's, as silver dollars were piling up in the treasury vaults at Washington, there were frequent predictions that the gold standard could not long endure. The so-called "balance of trade" was often against this country, and heavy exports of gold were called for. Foreigners were declared to be selling American securities, because of their loss of faith in our standard of value. Yet in all this decade practically no gold was demanded from the treasury in exchange for greenbacks. The total redemptions amounted to only about \$15,000,000. A change set in, however, in 1890. In that year \$6,000,000 were redeemed in gold; in 1891, \$9,000,000; in 1892, \$102,000,000; in 1893, \$84,000,000; in 1894, \$117,000,000; in 1895, \$158,000,000; and in 1896, \$78,000,000.

It is evident that mere doubt as to the monetary standard will not always set the "endless chain" in operation. Nor is the exportation of gold alone sufficient to turn the crank. In 1884, 1886 and 1889 the net exports of gold amounted to \$90,000,000, but there was no run upon the treasury in any one of those years. What condition existed in the 90's that was not present during the 80's? I think the answer must be abnormal currency expansion. Prior to 1890, new silver dollars were being injected into circulation in the form of silver certificates at the rate of about \$30,000,000 a year, but at the same time the bank-note circulation was decreasing, so that the net expansion of the currency did not amount to inflation. That the money supply did not become redundant is evidenced by the fact that in all but three years of the decade beginning with 1880 gold was imported. Our money supply in these years did not grow more rapidly than the need for money. After 1890, however, the increase in silver currency was

doubled, while at the same time the contraction of the banking circulation ceased. Consequent upon the inflation of the currency a steady export of gold set in and continued until 1897. In 1891 the net exports of gold were \$67,000,000; in 1893, \$87,000,000; in 1895, \$30,000,000; and in 1896, \$78,000,000. It is to the currency inflation which caused this steady outward flow of gold, kept up for seven years, that we must look for the force which set in motion the "endless chain."

It is necessary to have a clear idea of the causes of this gold movement. In the discussions of the time, and in the Congressional debates, the outward flow of gold was attributed entirely to Europe's loss of confidence in our money. European capitalists were said to be selling American securities and to be demanding gold in payment for them. In order to liquidate our great indebtedness to the Old World, it was explained, we were obliged to part with gold, even though we greatly needed it. Exporters of gold, not being able to obtain it from the banks, presented greenbacks and Sherman notes at the treasury windows, and so brought on that state of apprehension which resulted first in the panic of 1893 and then in the embarrassing and apparently useless bond issues of 1895-96.

This current and common explanation of the "endless chain" is, in my opinion, unscientific, inadequate and entirely incorrect. It is impossible for gold to flee from a country steadily for seven years unless the supply in that country is in excess of its needs. Granted that we were called upon by Europe to liquidate a large part of our indebtedness, gold is not the commodity with which that liquidation would be effected. As any one familiar with the first principle of foreign trade must admit, the liquidation of an international debt must be mainly in goods, not in gold. No country will send gold in payment of foreign indebtedness, so long as it has any other commodity with which it can part on more advantageous terms. The liquidation of international indebtedness means increased exports of goods. What goods shall be exported is determined by prices, foreigners naturally selecting those goods the prices

of which are relatively lowest. Gold is never one of those goods, except when its value is relatively less here than abroad. In other words, we exported gold in the first seven years of the last decade, for the simple reason that we had a surplus of gold. That is another way of saying that our money was redundant, and that in consequence an adverse balance of trade was created.

This is stating a mere truism in the theory of foreign trade; yet it is so important and has been so persistently neglected in discussions of recent financial events, that I do not feel like apologizing. Between June 30, 1890, and June 30, 1893, the monetary circulation of the United States received additions which it could not be expected to absorb. They came from three sources. First, the Sherman Act led to the issue of about \$150,000,000 treasury notes. Then came the increment from the gold mines of this country. This amounted to about \$100,000,000, of which probably \$60,000,000 became available for monetary use. Finally, the treasury's cash balance, although the revenues yielded a surplus each year, declined, because of bond purchases, from \$245,000,000 to \$121,000,000, so that \$124,000,000 was taken from the treasury vaults and put into circulation.¹ From these three sources the money in the banks and in the hands of the people received a net increment amounting to over \$300,000,000. The period between 1890 and 1893 was not one of remarkable expansion in business. The collapse of the Barings in 1890, startling the financiers of Europe and checking enterprise in various parts of the world, paralyzed the arm of the investor in this country and brought many undertakings to a standstill, particularly in the developing West. The prices of staple commodities during this period declined some twenty per cent. Under such circumstances, it is not remarkable that the monetary circulation could not absorb an increase equal to twenty per cent of the whole. It was this inflation of our money supply, and not loss of confidence in the monetary standard or European distrust

¹ Inasmuch as the public deposits in national banks during this period fell from \$37,000,000 to \$15,000,000, the net addition to the currency through treasury operations was only \$102,000,000.

of our securities, which led to gold exports in 1892, to the impairments of the treasury's gold reserve, to the disturbance of business credit, and so to panic.

The links in the "endless chain" are greenbacks, but the power at the crank which turns the chain is the necessity for gold exports produced by artificial inflation of the currency. It is for this reason that I regard the clause prohibiting the reissue of greenbacks to meet deficiencies of revenue as the most important feature of that part of the currency law which is designed to fortify the gold standard. Inflation of the currency so produced is quite as artificial and mischievous as inflation produced by the issue of paper money. This fact was illustrated by events in the three years following the panic of 1893. As is always the case after the culmination of a crisis which destroys capital and cripples entrepreneurs in every field of industry, business was flat, factories were closed, labor was unemployed and the need for money was greatly curtailed. A clue to the conditions prevailing in these three years is furnished by comparison of the deposits in commercial banks with those in savings institutions. The former declined; the latter increased. This, of course, did not mean that the savings of the people were increasing. It meant simply that capital, being unable to find profit in commercial enterprises, was seeking for a time some small return in old and well-known channels of investment.¹ Notwithstanding the fact that all signs indicated a lessening demand for money, additional money was being thrust into circulation from three sources. There was, first, the normal increase from the gold mines of the country. In the second place, the United States Treasury was daily paying out more than it received, the total deficit in these three years amounting to \$150,000,000. Finally, the national banks enlarged their circulation by some \$22,000,000.²

¹ As a result of their experience in these three years, many of the savings institutions in this country found themselves compelled to reduce their rate of return to depositors from four to three per cent.

² The circulation of the national banks in January, 1894, stood at \$193,000,000; by October, 1895, it had increased to \$207,000,000; and by October, 1896, to \$222,000,000.

These additions to the money supply held down the interest rate in New York City, to which the idle money gravitated, and so made that place the best market in the world for all forms of indebtedness. The prices of securities there were continually bolstered by the influx of money, which could find no employment except in the hands of speculators in stocks and bonds. As naturally as a ship runs before the wind, international securities came across the Atlantic and our gold, as well as our goods, went back in payment. For the inflation of the currency which kept the "endless chain" turning during this period and brought the United States Treasury to the verge of bankruptcy, the deficiency in the revenues was mainly responsible. The treasury was daily thrusting into the circulation money for which the people had no need.

Under the law of March 14, even though the same untoward set of circumstances arise again, there is reason for hoping that mischievous results will be prevented. The secretary of the treasury is allowed very little discretion: he must do the right thing at the right time. In the first place, if an outward movement of gold reduces his gold stock, he must sell bonds before the reduction assumes serious proportions. These bond sales, by absorbing idle money, will counteract the causes back of gold exports and thus tend to check the demand for the treasury's gold. Furthermore, — and, in view of recent experiences, this is most important, — if there is a deficiency of revenue, the secretary must not pay out the greenbacks which are released by the gold received in payment for bonds. This restriction, if wisely interpreted, means that the secretary, if there is a deficiency in the revenue, must cover that deficiency by the sale of bonds. Hence, if conditions like those which prevailed in 1895-96 should exist again, there would be bond issues for two purposes: (1) To replenish the gold reserve; (2) to make up the deficiency of the revenue. If the law should be thus interpreted, the available cash balance in the treasury would remain stationary, except in so far as it would be increased by the addition of greenbacks set free from the reserve fund in exchange for gold. This construction of the

law enables the secretary to contract the currency supply of the country at will, when such contraction is necessary to prevent an exportation of gold that threatens to embarrass the national exchequer. It would perhaps be well for him to make special bond issues for these two purposes. He has authority to do this, for, under the War Revenue Act of 1898, he may issue three per cent bonds to cover a deficit and, under the law of March 14, 1900, three per cent bonds to replenish the gold reserve.

The deficiency clause is construed by some to mean that the secretary, when a deficit exists, may pay out the redeemed greenbacks until the total deficit foots up a sum equal to the cash balance in the treasury at the time the deficit set in. For example, the available cash balance on June 14, 1900, was \$147,000,000. Under this construction, even though a deficit had then arisen in the revenues, the secretary might have gone on paying out redeemed greenbacks until the excess of expenditure over receipts equalled \$147,000,000. If this construction be accepted as correct, it is evident that the secretary will have practically no control over the money supply to help check the operation of the "endless chain." That was the trouble in 1895-96. The proceeds from bond sales in those years were poured back into the circulation almost as fast as they were received at the treasury, and so the forces at work drawing gold from the treasury were not counteracted. The more natural construction of the law makes the treasury department, in a sense, the regulator of the currency. In ordinary times it will be a wise policy for the secretary to maintain his available cash balance at nearly a uniform level, so that the operations of the department shall neither excite nor depress the money market. In periods of expansion, when stringency threatens, he may safely give some relief by increasing the deposits in the national banks. On the other hand, in periods of contraction, when gold exports are threatening the resources of the treasury, he has the power gradually to withdraw government funds from circulation and so to protect the gold reserve. With regard to the policy of the secretary when surplus revenues are

depleting the circulation, the law is not mandatory. In fact, it would be impossible to lay down any hard and fast rule, determining when the secretary should ease the money market by the purchase of bonds or by increased deposits in the banks. The proper manipulation of surplus revenues must be left to the discretion of the secretary of the treasury. Rising interest rates in New York City and a fall in foreign exchange rates, taken together, furnish pretty good evidence that the treasury department, if it is collecting surplus revenues, is absorbing money needed by the people and should generally warrant a purchase of bonds or increased deposits in banks. In general it will be safe to adhere to the rule that the cash locked up in the vaults of the treasury should be kept, so far as possible, at a uniform amount. In other words, the treasury's cash should be so managed as to interfere as little as possible with the natural developments of the money market.¹

The fact is worth noting that gold movements not caused by an artificial inflation of the money supply are not likely to embarrass the treasury department. An inflation due to the issue of new paper money, like the treasury notes of 1890, is artificial. So is an inflation due to a deficit in the national finances. So is an inflation caused by increased issues of bank notes based on bonds, as I shall explain later. When the money supply is enlarged in any one of these three ways to an extent sufficient to bring about an export movement of gold, the precious metal is liable to be taken from the treasury stock. But when gold exports arise from an increase in the gold supply of the country, the cause of the movement carries with it the means of effecting it. The banks find themselves able to part with gold during the year and yet maintain an undiminished stock. When the mines of the United States produce a surplus of gold, it is naturally exported, and the exporters get it either directly from the banks or from the treasury depart-

¹ This policy appears to govern the present secretary's management of the cash balance. Notwithstanding the extraordinary character of treasury operations during the last three years, they have not been permitted to work even a temporary contraction or inflation of the circulation.

ment in exchange for gold certificates. In 1889, 1890 and 1891 our net exports of gold footed up \$111,000,000, yet very little gold was obtained in these years from the treasury department by the redemption of greenbacks, and the gold reserve was not menaced.

III.

The new law makes five important changes affecting the national banking system: (1) It authorizes the issue of bank notes up to the par value of the bonds deposited, provided those bonds are the new two per cents for which the fives of 1904, the fours of 1907 and the threes of 1908 may be exchanged; (2) it permits the establishment of banks with a capital of \$25,000 in places of a population not exceeding 3000; (3) in the case of banks depositing the new two per cent bonds, it reduces the tax on the circulation from one to one-half of one per cent, the basis of the tax being the average amount of notes in circulation and not, as formerly, the total amount issued to the bank; (4) it repeals that part of the old law which prohibited a bank from increasing its circulation within six months after it had retired any portion of its notes; (5) it restricts the issue of notes of the denomination of five dollars to one-third of a bank's total issue.

Inasmuch as experience has shown that the national bank note has been incapable of performing the important service which justifies bank-note issues, it is difficult to find any good reason why provision should be made, as is done in this law, for the enlargement and perpetuation of the system. In fact, advocates of the measure in Congress advanced no reasons whatever. It was simply taken for granted that, since the security would be adequate, the bank notes must be good, and that the measure needed no further justification. Doubtless the desire of the Republican leaders to refund a large part of the national debt at a low rate of interest is at the bottom of the changes of the National Bank Act. It is morally certain that the United States could not sell two per cent bonds at par, unless they carried with them special privileges. Just as the

system was established during the Civil War for the purpose of creating a market for government bonds, so now it appears to have been amended for the same purpose.

In support of the amendments, two arguments have been urged which are worth examining. In reference to the increase in circulation which will naturally result, it is claimed that this is desirable, because it will economize the use of gold and at the same time supply the country with additional money when most needed. With the experience of 1895-96 so fresh in memory, one would hardly expect to find Congress deliberately planning to lessen the gold base of our monetary system. In 1896 it was estimated that our stock of gold amounted to \$600,000,000, but the real amount in the country was probably less. At the present time there is supposed to be nearly \$1,000,000,000 of gold in the country, although the officials of the treasury are unable to locate over \$750,000,000. The proportion of gold is less than fifty per cent of the total money supply. Doubtless this proportion might safely be reduced, except for the fact that the bulk of the credit money is government obligations, which depends for its parity upon the United States Treasury, an institution having no normal connection with business. If, for example, our fiduciary currency were issued by a large banking institution, like the Bank of England or the Bank of France, or if it were under the control of a few large banks, as is the case in Canada, it is quite possible that the gold stock of the country might safely be kept at less than one-half of the total money supply. Unfortunately, however, our monetary system is most awkward and most easily disturbed. Of all the great civilized nations of the earth which are using gold as money, the United States has the worst system and is at the greatest disadvantage. The gold standard is maintained here artificially and by main force. In France, Russia, Austria and Germany the responsibility falls upon a single bank in each country. That bank, being in close touch with business, is able to note the slightest change in the financial barometer. Through a gradual contraction or expansion of its circulation, it averts peril before the business community is aware

of the menace. The operations are all so natural, and so much in accord with the ordinary procedure of business men in the protection of individual credit, that they no more attract notice than do the heart pulsations of a healthy man. Each bank, in guarding its own solvency, protects and maintains the standard of value in its country. In England, owing to the restrictions upon bank-note issues, the matter is less simple. The Bank of England in times of stress is forced to advertise its anxiety and to call on the world for relief by the offer of high rates of discount; yet that bank is able to foresee danger and so take steps to minimize the evil in advance. In the United States, however, there is no single business institution, and no group of large institutions, in which self-interest, responsibility and power naturally unite and conspire for the protection of the monetary system against twists and strains. We have developed here a most elaborate system of deposit credits. Just as Shakespeare often makes the simplest word in the English language stagger under its burden of meaning, so we make every dollar carry a heavy weight of credit responsibility. Our money supports a great structure of promises to pay, which trembles whenever the foundations are disturbed. An export of gold, therefore, if it comes from the stock on which our credit system rests, and not from fresh supplies, is always a most critical matter; yet, because of the artificial character of our system of redemption and the impossibility of coöperative prescience among our great banking institutions, and because of the inelasticity of our banking circulation, the country is always liable to lose gold at times when it is needed to sustain confidence in the business world. So long as the United States preserves its present monetary system, prudence demands that its stock of gold be kept so abundant that the export of \$100,000,000, more or less, can neither embarrass the treasury department nor excite apprehension among business men. Otherwise, it is to be feared that the gold standard in this country will always be in a state of unstable equilibrium.

The argument for the act which is based on the assumption

that it will give the country more money, especially in the rural districts, where it is assumed to be most needed, is a typical sample of current fallacies with regard to the money question. The act will, of course, give the country no more money : it will simply add to its stock of paper money and take away from its stock of metal. Should the banks increase their circulation by \$200,000,000 during the next two years, the country will not have \$200,000,000 more money than it would have had, if the act had not been passed : it will simply have \$200,000,000 less gold in use as money. Nor will the act cause the slightest increase of the monetary circulation in the rural districts. If the country banks increase their issues, and if new banks with small capital add to the supply, a census would discover no more money in the pockets of the country folk a year hence than it would find there now. There would simply be a change in the character of the money, bank notes having taken the place of greenbacks and silver certificates. It seems hardly worth while to make these statements about the effect of the act on the country's circulation, yet the fallacies which call them out are given respectability by the prominence of the men who utter them, and it does seem necessary to call the attention of our statesmen to the fact that, when a country has once decided to use gold as its standard of value, no law can have the slightest effect upon the amount of money which that country or any part of it will absorb and utilize.

The national bank notes, as at present issued, are a much more dangerous element in the currency than the greenback or the silver dollar. This fact does not seem to be generally understood. On no other supposition is it possible to account for the indifference with which Congress has voted for a measure facilitating and perpetuating their issue. The national bank note is usually said to be inelastic. That is not strictly true. The circulation does expand and contract, but the changes in volume have practically no relation to the needs of business for money. The system is founded upon an ancient fallacy — namely, that the demand for capital is identical with

the demand for money. These two things are, of course, in fact entirely different. The one may increase, while the other is stationary. As a matter of fact, the demand for money is often decreasing while the demand for capital is gaining in strength. The Bank of England, during the restriction period at the beginning of the nineteenth century, when redemption of its notes was forbidden by law, furnished a spectacular exhibition of the evil effects of a confusion of these two demands. Its managers held that they could not inflate the currency with bank notes, so long as they issued them only in response to the demands of borrowers who offered good security, failing to see that increasing profits for the employment of capital within the country did not necessarily mean an increased need for a generally acceptable medium of exchange. Practical financiers and business men in London were so much in sympathy with the bank's view of the matter that the gulf between the bank note and the gold sovereign was currently regarded as due, not to a depreciation of the bank note, but to the appreciation of gold. One of the most useful services of the "Bullion Report" was its exposure of the unscientific character of the bank's policy in this respect. That report presents a very clear demonstration of the important truth that a bank of issue must regulate its circulation, not in accordance with the demand for loans, but in accordance with the rise and fall of foreign exchange rates, an export of gold indicating under almost all conditions an excessive issue of bank notes.

Underlying the national bank-note system is the assumption that an increasing demand for money will be accompanied by a rise in interest rates and a decline in the prices of securities, so that banks will be able to buy the security for their notes at low figures and furnish the needed increase to the currency. Unfortunately, these assumptions are seldom in accord with the facts. Rising interest rates, due to the increase of opportunities for the profitable employment of capital, are not always accompanied by a need for more money in the hands of the people. They do, indeed, generally indicate that the total volume of exchanges in the country is swelling, but the increase

is usually more than taken care of by the expansion of the credit system which results from the growth of confidence caused by good times. The conditions do not admit of exact analysis. We know merely that bank loans and bank deposits may be much swollen by the call for capital from developing industries, and yet that the amount of money needed by the people for their daily exchanges need not greatly increase. There is merely a need for increased bank reserves, but that need cannot be met by the issue of bank notes.

Furthermore, it is not true that the prices of securities usually decline as the rate of interest moves up. There are three distinct rates of interest in the money market, each of them dependent upon different sets of demand and supply relations. There is the commercial rate, which depends upon the amount of capital or loan funds¹ in a country seeking investment for periods of from thirty to ninety days. The demand for this capital comes from merchants and manufacturers. There is the investment rate of interest, which is paid upon loan funds seeking investment for a period of years. These funds are supplied by people who do not wish to employ their savings in active business, and the demand comes chiefly from great private and public corporations. There is also the call-loan rate of interest, which is the rate paid by the speculator in stocks or produce. The speculator stands among borrowers as a residual claimant upon capital. He gets temporary control of capital while it is *en route* from the saver to the entrepreneurs, and he is forced to bid a rate high enough to cause it to rest in his hands a few days. When the amount of capital seeking direct employment is larger than the demand,

¹ Although the terms "capital" and "loan funds" represent different concepts, I use them as synonyms, because under analysis they revert to the same thing—that is, the wealth saved for productive purposes. The economist regards the rate of interest as related to the supply of capital; the practical man thinks of it as dependent upon the amount of money in banks, by which he means the lending capacity of banks. The banks, of course, do not lend capital: they lend credit, the power to obtain capital. As this lending power comes from the savings of the community, it rises and falls with changes in the amount of capital seeking employment, the connection between the two being as necessary as that which phrenologists suppose to exist between thought-power and brain-bulk.

even though for a brief period, the speculator names his own rate; but within a week changed conditions may force him to borrow at a rate which would put all entrepreneurs into bankruptcy. These three interest rates are not to be explained merely by the general expression of demand for and supply of capital. They depend upon entirely different sets of circumstances, and they often fluctuate without much relation one to the other. It is quite possible for the commercial rate to be advancing on account of prosperous industries, while the investment rate remains unchanged. The prices of bonds depend entirely upon the rate of interest satisfactory to the investor looking for long-time uses of capital. That rate may remain stationary or even be falling off, while rising profits in business are pushing up the rate on commercial discounts. So it happens that the prices of government bonds are often firm at the very time when increasing activity in the industrial world is calling for additions to the currency, so that the national banks cannot increase their circulation without first locking up part of their loan funds in securities that yield a very small return.

Under the present system, a banker must take into account three different circumstances, when considering the advisability of increasing his circulation: (1) Is there any danger that the price of government bonds will fall on his hands? (2) Will he be able to get the bank notes into circulation? (3) Will he be able to keep them in circulation during a possible lull in business activities? Only one of these questions has anything to do with the need for money in the community. If the second question were the only one he was obliged to consider, then the system would yield an elastic currency; but the other two questions cannot be ignored. In fact, to the practical banker the first question probably seems more important than either of the other two, and the third quite as important as the second. If government bonds are selling at what is regarded as a high price, so that they yield (say) less than two per cent on the purchase price, a banker knows that he is taking a risk when he buys them. A war in Europe, a political accident in

this country, over-speculation in Wall Street — any such untoward event, even though the credit of the United States is not affected, may cause a drop in bond quotations. On the other hand, he may well doubt if they will ever sell at a higher level. In his uncertainty with regard to the probable future of bond quotations, he will not make the investment, even though he has evidence that the community is absorbing daily more and more money and that he will be able to put into circulation \$100,000 more of bank notes ; for the small profit from an increased issue of bank notes will not offset the chance of loss from a decline in government bonds.

But grant that prices in the bond market are satisfactory. A banker must then consider whether or not he will be able to keep new notes in circulation for a period worth while. It is comparatively a simple matter for a bank to decide upon its ability to float an issue of bank notes. That can be determined by the nature of its daily receipts and payments. If the customers are calling upon the paying-teller for bills of the right denominations, — say, fives, tens and twenties, — and if the receiving-teller is taking in a large proportion of legal-tender money, or if the payments through one window exceed the receipts at the other, a banker is justified in concluding that the community can be made to absorb an additional quantity of bank notes. But he does not know how large that quantity will be ; nor does he know for how long a period the community will have use for the increased supply of money. Now, it is important that a bank issuing notes secured by the deposit of bonds should be able to keep all of its notes in circulation. Notes lying in its own vaults represent capital which, from the banker's point of view, is wasted ; for it cannot be made the basis for an expansion of deposits and discounts, since the bank note does not count as reserve. Thus, if a bank has taken out notes to the amount of \$100,000 and is able to keep only \$50,000 in circulation, it may be losing more than the interest on \$50,000. If it had, instead of the notes, the \$50,000 or \$55,000 which it paid for bonds, its credit business would be capable of an expansion equal to \$200,000 ; for

a bank with \$50,000 in legal-tender money can with safety take care of \$200,000 in deposits. Hence, the banker who locks up capital in bonds and takes out notes which he cannot issue, not only runs some risk of loss through changes in the market for government bonds, but renders a portion of his capital entirely unavailable for employment in the most profitable channels open to a bank.

To make this thought clear to readers not familiar with banking operations, let us take the case of a bank which decides to purchase \$100,000 of the new two per cent bonds and to issue \$100,000 in bank notes. Let the bonds be bought at par. To understand the chances of profit, we must consider what might have been done with the \$100,000 legal-tender money, had bonds not been purchased, and what can be done with the \$100,000 in bank notes. With the \$100,000 legal-tender money, since a reserve of twenty-five per cent is regarded as sufficient for any bank in the country, the bank could increase its loans by at least \$400,000, the borrowers opening deposit accounts. At six per cent, the possible profit to be obtained by the fullest use of this \$100,000 legal-tender money will be \$24,000. Let us look at the other side of the case. If a bank invest the \$100,000 legal-tender money in bonds, the \$100,000 in bank notes which it receives from the comptroller, not being capable of serving as the basis of deposit credits, at first sight would appear to give the bank a lending power of only \$100,000, the return upon which would be \$6000. Apparently, therefore, the bank must be a loser by the issue of notes. There is a way, however, to make the note issue the more profitable operation. The notes must be exchanged for legal-tender money, and the public must be an involuntary party to the exchange. The bank's customers must be willing to take bank notes from the paying-teller, while they are turning in legal-tender money at the window of the receiving-teller. If the bank can put this operation through and pay out its \$100,000 of bank notes, its store of legal-tender money increases, and so it may gradually expand its loans and deposit credits by four times the amount of notes issued, just as it might have done

had it not purchased bonds. If this operation is successfully carried through, the bank's net profits from the issue of bank notes amount to the interest on the bonds, less the circulation tax and the cost of the bank notes. But if the bank does not succeed in getting the notes into circulation or in keeping them out, its loss is much more than the difference between two per cent and six per cent on \$100,000. Its possible loss, evidently, is the difference between two per cent and twenty-four per cent; for, with the unissued bank notes in its possession, it is incapable of expanding its credit business through loans and discounts, even though the public is calling for such expansion.

This analysis, showing how small are the profits and how great are the possible losses, discloses the real reason for the inelasticity of the national bank-note system. Under normal conditions, it is unwise for a bank to issue more notes than can be kept constantly in circulation. During a time of expansion, when there is increasing demand for money, a prudent banker shrinks from taking out more notes, lest a lull may set in and the notes be returned for redemption. Hence, the total circulation of bank notes at any time never exceeds the amount which, in the opinion of bankers, can be kept afloat throughout the year, in dull times as well as in good times. The level of the bank's circulation, therefore, may be said to be fixed by the minimum demand for money in the country. If it rises above this minimum, the bankers take the risk of a loss much in excess of the possible profit accruing from a temporary increase of circulation. We have here a satisfactory explanation of the statistics of the banking circulation in this country since 1865. Its volume has never increased in response to the increasing needs of the community or fluctuated in accordance with temporary changes in the demand for money. Changes in the circulation have been infrequent and have followed lines entirely unconnected with the monetary demand.

But for two provisions in the National Bank Act, it is possible that the banking circulation would have displayed some elasticity of the right sort. I refer to the provision prohibiting a bank from increasing its issues within six months after it has

retired any portion of its circulation and to that restricting the total retirement of bank notes to \$3,000,000 a month. These two provisions, which were intended to prevent sudden contraction of the currency, would be fatal to the useful operation of the system, even if that were otherwise possible. The first provision, which under any circumstances would make bankers cautious about the curtailment of issues, has probably had little effect upon the total circulation during the last twenty years; for within that period the profits from the issue of bank notes have usually been so small that bankers have given them very little consideration. It is repealed in the act of March 14, but the increased liberty thus given to bankers is likely to be of little avail. The second provision is alone sufficient to render the system ineffective. It is an excellent illustration of the mischief which legislative interference with business is always liable to work. It was intended to prevent a sudden contraction of the currency. But this is a matter which can be safely left in the hands of bankers and business men, since the public will not give up bank notes so long as it has use for them. A harmful contraction of the currency through the retirement of bank notes is impossible. Furthermore, even though the bankers could get possession of the notes when needed by the public, self-interest would prevent a rapid contraction of the currency, for the increasing supply of bonds on the market would lower the price and so furnish a check to the operation. The limit set upon the retirement of notes is ridiculously small. In Canada, whose total money supply is only about four per cent of that of the United States, the banking circulation is left free to correspond to the needs of business and often varies in amount by \$3,000,000 a month. In this country it is quite possible that at certain seasons monthly fluctuations equal to \$30,000,000 would not exceed the changes in the public demand for a medium of exchange. However, that is a matter which can be determined only by experience: it is not to be fixed by law, any more than is the amount of ice which a city shall consume in the various summer months.

The worst effect of the \$3,000,000 restriction is of a kind

probably not anticipated by the framers of the law. While ostensibly designed to prevent contraction, in reality it prevents expansion to meet any temporary need for an increase in the money supply. It is possible that, if this restriction were removed, the volume of bank notes in this country might at times vary with the needs of different seasons. Yet that is only a possibility. With this restrictive provision left in force, as it is by the law of March 14, the bank-note system drags a ball and chain which renders anything like elasticity impossible. The banks, for example, dare not provide beforehand by the issue of notes for the autumn drafts upon the currency; for, should they do so, the notes would be on their hands through the winter and spring, and part of their capital or loan funds would thus be tied up in a form unavailable for the most profitable use. The law of March 14 moved in the right direction, by its change in the basis of taxation, making it the circulation outstanding instead of the total notes issued to a bank by the comptroller. But another step is necessary before it will be possible to learn from experience whether or not a banking circulation based on bonds can in any measure serve the business interests of a community. The \$3,000,000 restriction should be removed. Then, if every possible facility were afforded the banks for the contraction as well as for the expansion of their issues, so that their capital might glide quickly and easily from a two per cent bond investment back into the channels of commerce, there would be some reason for hoping that the system would furnish a useful and elastic, as well as a safe, bank note.

I have dwelt upon the conditions limiting the increase of note issues so long that the reader might infer that dangerous inflation from the bank note need not, in my opinion, be apprehended. This inference is not warranted. It must be borne in mind that a banker takes several circumstances into consideration, when deciding upon the purchase of bonds for the issue of notes. If government bonds, in his opinion, are depressed and are likely to rise in price, he is tempted to make special effort to force more notes into circulation. If, at

the same time, the money market is dull and he has on hand a surplus of legal-tender money for which he sees no chance of employment as a reserve against an expansion of discounts and deposits, the low prices of government bonds become doubly attractive to him. Bankers were in a situation of this sort in 1895 and 1896. Then they pushed more notes into circulation, and the legal tenders which those notes displaced found their way to New York City, there coöperating with other forces in the operations which resulted in a continual exportation of gold. Such a situation may arise again and the banks may inflate the currency and so help to bring on an export of gold in quantities sufficient to compel the government to sell bonds in order to maintain its reserve. It must be borne in mind that the national bank note possesses a certain legal-tender quality itself. It is receivable at par by all national banks and by the government, and must be accepted by all creditors of the government except bondholders. This enforced receivability of the note gives it a very large field of circulation. It serves as the counter-money of all sorts of financial institutions; and one national bank often pays out the notes of other banks, rather than go to the expense of expressing them to a sub-treasury for redemption. Owing to all these circumstances, it is impossible to determine what the maximum circulation of the national bank note would amount to under the most favorable conditions. We know merely that inflation is possible, at a time when it will be most dangerous. We know, also, that the national bank note, even under the best conditions, fails to be of any service to the community. In the currency of the country it is as useless as a sail on a tugboat, which might in rough weather upset the craft.

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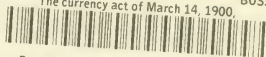
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The currency act of March 14, 1900,



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